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External Confirmations – Issues Paper

This Issues Paper is set out under the following headings:

- A. Objective and scope of the project
- B. Background and current environment
- C. Existing standards and research
- D. Issues identified by the Task Force

A. OBJECTIVE AND SCOPE OF THE PROJECT

The objectives of the project, as set out in the project proposal approved by the IAASB in December 2005 are:

- To determine whether to change the extent of the obligation on the auditor to obtain external confirmations [emphasis added]; and
- To develop, as necessary, additional standards and guidance to improve the effectiveness of the external confirmation process, and the reliability of confirmation responses, including that relating to audit evidence obtained with respect to lawyer letters.

The project proposal indicates the project's scope as follows:

To update and strengthen the standards and guidance in ISA 505, "External Confirmations" and Part C: Procedures Regarding Litigation and Claims of ISA 501, "Audit Evidence" addressing the auditor's use of external confirmations.

The project proposal also indicates that the project's primary focus is to review the circumstances for which external confirmations (a) are required, and (b) when they are not, within the context of the audit risk model. In developing recommendations, an understanding of environmental factors affecting the use of external confirmations and lawyer letters as a source of audit evidence will be obtained through consultations with key stakeholders and other research. The project's secondary focus is to identify whether there is a need, if any, to amplify the standards and guidance in ISA 505.

B. BACKGROUND AND CURRENT ENVIRONMENT

A number of recent high profile financial failures have elevated awareness of the use of, and consideration of the reliability of, external confirmations as audit evidence. Some regulatory authorities around the world are calling for more rigorous requirements pertaining to the use of external confirmations by the auditor.

In addition, national standard setters have noted a need to enhance auditing standards and guidance relative to the use of external confirmations.

Specific developments of relevance include:

- In the United States, a review of the equivalent national standard by the US Panel on Audit Effectiveness and the US Auditing Standards Board identified several areas where guidance

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on the use of external confirmations could be strengthened; in particular, the more precise articulation of the considerations that should be present to overcome the presumption that it is necessary to send accounts receivable confirmations.

- In Europe, the European Commission (EC) indicated that some Member States reported areas where ISA 505 may deserve improvement in substance, specifically in relation to specifying a requirement that auditors shall obtain for each audited entity direct confirmation for each bank and related types of accounts, and from each lawyer with which the audited entity has worked.
- IOSCO suggested that ISA 505 may need to be strengthened, recommending amongst other things that the ISA should indicate the circumstances when use of confirmations should be required – for example, confirmation of bank balances and other matters such as guarantees, covenants and terms of related agreements, and accounts receivable – and that its guidance pertaining to negative confirmations should be reconsidered.

Set against these developments is the fundamental question of whether, or under what circumstances, requiring the use of external confirmations is appropriate in the international context, and whether such practice would, in fact, enhance the persuasiveness of audit evidence obtained by the auditor. Relevant observations include the following:

- The issue of whether the ISA should require the use of confirmations was addressed by the International Auditing Practices Committee (IAPC, predecessor to the IAASB) when it revised ISA 505 in 2001. The IAPC concluded that the quality, timeliness and response rates to confirmations varied widely in different cultural environments, and it was not appropriate to mandate the use of confirmations as an audit procedure. The extant ISA, accordingly, requires the auditor to determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence, but does not mandate their use in any particular circumstance.
- Some are questioning the usefulness of auditors' requests for confirmation even in those jurisdictions where such practice represents the norm. An increasing number of entities decline to respond to third party confirmation requests. These circumstances suggest that the legal or regulatory environments in individual jurisdictions may impede the effectiveness of the auditor's external confirmation procedures.
- In some cases where a confirmation has been responded to, there is a question of whether responding entities are practising rigor in the preparation of such responses, raising a very real concern by auditors regarding the reliability of confirmation responses.

C. EXISTING STANDARDS AND RESEARCH

EXISTING STANDARDS

Existing ISA 505 was issued in 2001. Its purpose is to establish standards and provide guidance on the auditor's use of external confirmations as a means of obtaining audit evidence. ISA 505 does not require that external confirmations be requested by the auditor. Paragraph 2 of ISA 505 states:

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The auditor should determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence at the assertion [level]. In making this determination, the auditor should consider the assessed risk of material misstatement at the assertion level and how the audit evidence from other planned audit procedures will reduce the risk of material misstatement at the assertion level to an acceptably low level.

Existing ISA 501, Part C, provides guidance on the procedures an auditor should perform with respect to litigation and claims. Paragraph 32 requires the auditor to carry out procedures to become aware of any litigation or claims involving the entity which may result in a material misstatement of the financial statements. Paragraph 33 states:

When the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified or when the auditor believes they may exist, the auditor should seek direct communication with the entity's legal counsel.

At the time when ISA 505 was first developed, there had been a number of academic studies assessing the reliability of external confirmations of receivables as audit evidence. For example, Caster¹ in 1990 concluded from his study that using confirmations to assess the error rate in the population would have resulted in severe underestimation of the actual number of errors (emphasis added).

Problems have continued to surface with respect to the use of external confirmations by auditors. In the US, for example, a June 1998 Journal of Accountancy article cited problems identified by peer reviewers in 1995 that indicated practitioners were not complying with, and perhaps did not understand, the US requirements for external confirmations. Similar findings were reported in the Report and Recommendations of the Panel on Audit Effectiveness in 2000.

In 2004, the IAASB updated the audit risk model. In updating the audit risk model, conforming amendments were required to ISA 505. The new audit risk model emphasizes that the nature, timing and extent of the auditor's procedures are designed to address the risks of material misstatement at the financial statement assertion level; that as risk increases, so too is the need for the auditor to obtain more relevant and reliable audit evidence; and that external confirmations are examples of procedures that auditors might perform in higher risk situations. It is too early to determine whether, or how, this reference in the audit risk model standards is impacting auditor performance.

TASK FORCE RESEARCH

The IAASB staff conducted a brief survey of national standard setters with respect to bank confirmations and legal letters. Responses to the questionnaires, which were sent out in November 2005, were received from 26² national standard setters. The Appendix to this Issues Paper presents an overview of the responses.

The Task Force also sought input from practitioners to obtain further information regarding why they believe external confirmations may not always be a reliable source of evidence. A short

¹ "An Empirical Study of Account Receivable Confirmations as Audit Evidence," Auditing: A Journal of Practice and Theory, 1990

² Europe (22), Asia (1), Africa (1) and North America (2).

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survey was sent to the members of the IFAC Small and Medium Sized Practices (SMP) Committee and to the Forum of Firms. The results are summarized in the Appendix.

Project staff performed a literature search and contacted leading academics to identify whether there have been any recent studies on this issue which should be taken into account. Staff concluded that there have been no major academic developments since the 1990s in this respect. However, there have been some technology developments since the 1990s that may provide opportunities for improvements to elements of the confirmation process.³

PRELIMINARY CONCLUSIONS

The preliminary conclusions of the Task Force from considering academic research and its own research are as follows:

- Use of external confirmations is considered to be an important procedure, especially in higher risk situations. External confirmations can provide a source of relevant and reliable audit evidence.
- In recognizing this importance, there is an underlying presumption that external confirmations are a more relevant and reliable source of evidence than other audit procedures. However, there is little support in existing research for this presumption.
- In today's environment, where business is more complex and there is an increasing reluctance of third parties to respond to confirmations, reliability of external confirmations continues to be an issue and there are limits to the extent to which the auditor can affect the reliability of external confirmation audit evidence.
- The issues concerning the reliability of audit evidence obtained by auditors from external confirmations may, to some extent, be a consequence of ineffective execution of the confirmation process.

D. ISSUES IDENTIFIED BY THE TASK FORCE

Issue 1: Does the Existing ISA 505 Fit in the Audit Risk Model?

Summary of the Issue

In addressing the project objectives and scope, the Task Force considered whether the existing ISA 505 is appropriately positioned in relation to the audit risk model.

Task Force Deliberations

While conforming amendments were made to ISA 505 when ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" and ISA 330, "The Auditor's Procedures in Response to Assessed Risks" were issued, the Task Force made the following observations about ISA 505:

³ See, for example, "Automating the Confirmation Process – How to Enhance Audit Effectiveness and Efficiency," by George Aldhizer and James Cashell, CPA Journal April 2006.

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- Paragraph 2 of ISA 505 states “The auditor should determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence at the assertion [level].” The Task Force believes that this requirement creates a presumption that confirmations should be considered for all assertions. The requirement also implies that external confirmations will be necessary in certain circumstances but does not define those circumstances. The audit risk model requires the auditor to determine the nature, timing and extent of audit procedures to respond appropriately to assessed risks of material misstatement at the assertion level.
- The second sentence of paragraph 2 of ISA 505 states: “In making this determination, the auditor should consider the assessed risk of material misstatement at the assertion level and how the audit evidence from other planned audit procedures will reduce the risk of material misstatement at the assertion level to an acceptably low level.” The Task Force believes that this provision creates the presumption that confirmations represent a residual activity (in the sense that the need for confirmations is determined once all other planned procedures are considered first) and downplays situations where confirmations might be a more effective audit procedure than other planned procedures with respect to a specific risk for a specific assertion.
- ISA 505 provides guidance on execution of the confirmations process. There appears to be a need for more guidance on executing an effective confirmations process when confirmations are determined to be an appropriate audit procedure to address risks of material misstatement.
- Although ISA 505 addresses issues of reliability of confirmation responses, the Task Force believes that, given the research and experience with confirmations highlighting that confirmations are often unreliable, ISA 505 does not appropriately emphasize the importance of considering issues relative to the reliability of confirmation responses.

Task Force Preliminary Conclusions and Proposals

The Task Force believes that ISA 505 does not fully address where external confirmations fit within the audit risk model. The Task Force proposes that the project improve the linkages in ISA 505 between the audit risk model and the decision to request external confirmations. The Task Force proposes to develop an approach that requires a more rigorous assessment of whether to seek confirmations than under the extant ISA (which assessment would need to be documented). This may involve more clearly linking certain types of confirmation requests with specific financial statement assertions. Paragraphs 1 to 16 of ISA 505 would be revised accordingly.

Matter for IAASB Consideration

1. Does the IAASB agree that extant ISA 505 should be revised to more clearly address the use of external confirmations in the context of the audit risk model?

Issue 2: When, or Under What Circumstances, Should Confirmations be Sought?

Summary of the Issue

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Given the discussion in Issue 1, the Task Force sought to identify when the auditor should use confirmations in an audit of financial statements.

Task Force Deliberations

As part of designing the nature, timing and extent of audit procedures, the auditor determines the audit evidence needed to reduce risk to an acceptably low level. Before designing audit procedures, the auditor considers:

- What evidence the auditor needs to obtain to address the assessed risks; and
- What the most effective means is of obtaining that evidence.

In designing the nature, timing and extent of audit procedures, the Task Force believes that the auditor ordinarily will seek to obtain confirmations when:

- (a) Confirmations are the most efficient means of obtaining the required audit evidence to reduce assessed risk to an appropriately low level. For example, if inventory exists at a remote location in the custody of an independent third party, the auditor may visit the location and attend the physical inventory count to establish that quantities exist. However, a more effective and efficient method of obtaining evidence might be to obtain a confirmation directly from the inventory custodian.
- (b) The auditor concludes that obtaining audit evidence from a third party is the only way that the auditor will be able to obtain sufficient appropriate audit evidence, because there are not other audit procedures that the auditor can perform to reduce assessed risk to an appropriately low level. In this situation, obtaining a confirmation is necessary because it is the only means of obtaining sufficient appropriate audit evidence. For example, when the entity is the subject of adverse litigation, obtaining a confirmation from legal counsel may be the only appropriate means of obtaining evidence about management's assertion regarding measurement of the potential legal liability.

Task Force Preliminary Conclusions and Proposals

The Task Force believes that distinguishing the two situations discussed above in the ISAs is important due to the differing consequences. For example, under (a), if the auditor does not receive a response to a confirmation request, there are other audit procedures that the auditor can perform that may provide the evidence necessary to address the risk; under (b), if the auditor does not receive a response to a confirmation request there may not be other procedures that the auditor can perform to address the risk.

The Task Force proposes that ISA 505 should be revised to clearly articulate these two situations. This enhanced guidance should assist auditors in determining the most effective audit procedures to perform in a given situation.

The Task Force also proposes to consider whether it would be useful to provide guidance on the use of confirmations with respect to specific financial statement items where external confirmation is common practice, such as accounts receivable, bank balances, accounts payable, etc. Such guidance would be application guidance under the clarity format and provide guidance

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relative to effectively executing the confirmation process when a determination has been made that external confirmations will be requested.

Matters for IAASB Consideration

- 2a. Does the IAASB agree with the formulation of when the auditor should seek to obtain confirmations?
- 2b. Does the IAASB agree that ISA 505 should be revised to provide further guidance on the two situations noted and on the effective execution of the confirmation process?

Issue 3: How Does the Auditor Conclude that Evidence Received from External Confirmations is Reliable?

Summary of the Issue

An underlying presumption for the use of external confirmations is that they provide reliable audit evidence. However, there are issues concerning the reliability of confirmations as audit evidence. Many of these issues are outside of the auditor's control although some may be the result of inadequate execution by auditors (e.g. over-reliance on confirmations). The question is whether changes to the ISAs can improve the reliability of confirmations auditors obtain.

Task Force Deliberations

ISA 330 indicates that the higher the auditor's assessment of risk, the more reliable and relevant is the audit evidence sought by the auditor from substantive procedures. ISA 500, "Audit Evidence" provides guidance on the characteristics of relevant and reliable audit evidence. Based on ISA 500 and existing ISA 505, the Task Force identified the following features of audit evidence that apply to confirmations:

- When the confirming party is independent of the entity, evidence from confirmations is more reliable.
- When confirmation is provided by someone with appropriate qualifications, it is more reliable.
- When confirmation is of objective information, it is more reliable.

The Task Force considered academic research as well as anecdotal evidence from recent financial scandals in this area. It also conducted short surveys with the SMP Committee and the Forum of Firms. The results confirmed three things: first, reliability of a confirmation response is not fully within the auditor's control because there is a third party involved; second, auditors do not appear to be well-suited to identify when a response is not reliable – accordingly, auditor over-reliance on confirmation responses is a very real concern; third, reliability of responses can be improved when the auditor requests confirmation of information from an appropriate party.

Task Force Preliminary Conclusions and Proposals

The Task Force believes the presumption that confirmations will provide reliable audit evidence may be overstated. For example, while confirmation may appear to be an appropriate response to

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an assessed risk, this conclusion is valid only to the extent that the confirming party is diligent in preparing its response to the confirmation request. Accordingly, the Task Force believes that, prior to seeking to obtain confirmations, the auditor should assess whether external confirmations will, in fact, provide relevant and reliable audit evidence. The Task Force believes that ISA 505 should recognize more explicitly that there are inherent limitations to the confirmation process that vary depending on the circumstances and that, in determining the nature, timing and extent of use of confirmations, the auditor should assess the likelihood that confirmations will provide relevant and reliable audit evidence.

The Task Force also believes that once the auditor has determined that confirmations should be requested and that they are likely to provide relevant and reliable audit evidence, the emphasis should be on ensuring that the confirmation process should be conducted properly.

The Task Force proposes to develop guidance to assist auditors in determining whether confirmations are likely to provide relevant and reliable audit evidence.

The Task Force proposes to expand on the guidance in ISA 505 dealing with the design and effectiveness of the confirmation process. Research undertaken by the Task Force indicates that poor confirmation design often results in non-responses or discrepancies, and reduces the reliability of confirmation responses. Accordingly, more guidance would be useful. In addition, the Task Force proposes to more clearly link confirmation design with the risk and assertions being addressed.

In responding to regulatory concerns about a lack of professional skepticism by auditors when reviewing confirmation responses, the Task Force proposes to provide more guidance to assist the auditor in assessing the reliability of responses. Paragraph 33 of ISA 505 would be expanded. This guidance would include considering more rigorous procedures to determine the reliability of confirmation responses.

The Task Force also proposes to expand the guidance addressing confirmation exceptions and non-responses. This guidance will refer to a recently issued AICPA Practice Alert that provides information on the performance of alternative procedures.

Finally, the Task Force proposes to emphasize that, once the auditor has determined to seek confirmations, it is important to design an effective confirmation process as set out in the ISA in order to obtain relevant and reliable audit evidence.

Matter for IAASB Consideration

3. Does the IAASB agree that ISA 505 should be revised to provide more guidance on improving the relevance and reliability of audit evidence obtained from confirmations and on the general direction of the Task Force in this area?

Issue 4: Under What Circumstances can the Auditor Use Negative Confirmations?

Summary of the Issue

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Concerns have been raised that auditors are placing excessive reliance on negative confirmations as a source of audit evidence.

Task Force Deliberations

The Task Force noted that the ISA provides for the use of negative confirmations. The ISA includes limited warnings about the limited assurance that negative confirmations provide. The ISA does not include guidance on dealing with responses to negative confirmations.

The Task Force considered whether use of negative confirmations should be prohibited or be limited to specific circumstances. The Task Force recognizes the limitations associated with negative confirmation requests. The Task Force, however, does not believe that an ISA should prevent an auditor from performing a particular procedure simply because it provides limited assurance, but that the auditor should understand the limitations of the assurance obtained from such procedures.

Task Force Preliminary Conclusions and Proposals

The Task Force concluded that negative confirmations may be useful in specific circumstances, particularly when there is a strong incentive for recipients to respond to the request. In addition, the Task Force believes that negative confirmations should only be used to address assertions with low risk of material misstatement.

The Task Force proposes that the ISA not preclude use of negative confirmations to obtain audit evidence. However, the guidance in the ISA should be enhanced.

The Task Force proposes to expand the guidance in paragraphs 21-24 of ISA 505 to articulate more clearly the limitations on the level of assurance that can be obtained through the use of negative confirmations and reaffirm that negative confirmations should not be used to address high risk assertions.

Matter for IAASB Consideration

4. Does the IAASB agree with the Task Force recommendations for dealing with negative confirmations?

Issue 5: What Should be Done with ISA 501 Part C?

Summary of the Issue

The current guidance in ISA 501 dealing with legal confirmations covers several matters:

- Requirement to become aware of litigation and claims.
- When confirmation of litigation and claims is required.
- The process for communication with legal counsel.
- Considerations when management does not give the auditor permission to communicate with legal counsel.

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The Task Force believes that the guidance on this particular subject may be more appropriately located within the ISAs. The issue in relocating the guidance is that there is no obvious alternative.

Task Force Deliberations

The Task Force considered the relationship between ISA 501 and ISA 505. An auditor following the requirements of proposed ISA 505 often will identify risks arising from legal claims that can only be addressed by obtaining a legal confirmation. Accordingly, auditors will need to obtain legal confirmations on audits where such risks exist. Where such risks do not exist, however, the Task Force believes that other procedures may be appropriate.

The Task Force considered whether the guidance in ISA 501 Part C should be relocated to ISA 505.

Task Force Preliminary Conclusions and Proposals

The Task Force concluded that there is a logical connection between ISA 501 and ISA 505, as they both deal with external confirmations. However, the requirement to become aware of litigation and claims in paragraph 32 of ISA 501 does not logically fit within the requirements of ISA 505. Accordingly, the Task Force concluded that this requirement likely would have to be relocated, such as to ISA 315 (risk assessment procedures). The remaining material in the ISA appears to fall within the proposed requirements for ISA 505. The Task Force concluded that the final positioning of the material in ISA 501 Part C will depend on the results of the discussion of the issues surrounding ISA 505.

The Task Force proposes to discuss ISA 501 in more detail in due course. It expects that legal confirmations will be included in ISA 505 as an example of a type of confirmation to address risks relating to specific assertions and much of the existing guidance on obtaining a legal confirmation will be retained as application guidance in ISA 505.

Matter for IAASB Consideration

5. Does the IAASB agree with the preliminary conclusions and proposals of the Task Force relative to relocating ISA 501 Part C?

Issue 6: Should Requesting External Confirmations to Address Certain Financial Statement Assertions be Made Mandatory?

Summary of the Issue

Some regulators have recommended to the IAASB that requesting bank and legal confirmations be made mandatory. As explained in Section B above (Background and Current Environment), comments have been received from both the EC and IOSCO in this regard. Some national auditing standard setters also include such requirements in their standards. A fundamental question the Task Force considered is whether ISAs 501 and 505 should be revised to make confirmations mandatory with respect to certain financial statement assertions.

Task Force Deliberations

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The Task Force examined this issue from two perspectives. First, is there a place within the audit risk model for making confirmation requests mandatory? Second, if requesting confirmations is made mandatory, what will be the implications for auditors and audit quality?

When considering the first perspective, the Task Force raised the following concerns:

- The audit risk model requires the auditor to design the nature, timing and extent of audit procedures based on the assessed risk of material misstatement at the assertion level. Such design takes account of other procedures that the auditor may perform to obtain appropriate audit evidence and allows for professional judgment. Mandating confirmation requests does not reflect the interaction of different audit procedures, the assessment of risk or the importance of professional judgment.
- The audit risk model allows the auditor to take into account the reliability of audit evidence to be provided by confirmations in determining audit procedures to perform to obtain sufficient appropriate audit evidence, whereas the underlying presumption in making confirmations mandatory is that confirmations provide relevant and reliable audit evidence and will always be used.
- The audit risk model also provides for professional judgment in evaluating the subjectivity inherent in the nature of the item being confirmed by the auditor. For example, the confirmation of highly subjective amounts, such as litigation claims, may provide less reliable audit evidence than the confirmation of objective amounts such as bank balances. However, mandating confirmation requests does not recognize the subjectivity in the item being confirmed.

The Task Force expressed a number of concerns when considering the second perspective:

- Making confirmation requests mandatory does not recognize the fact that a successful confirmation is dependent on the confirming party being engaged in the process. Whether the confirming party is so engaged is beyond the auditor's control.
- Given that responses to confirmations often are unreliable, auditors could be put in the position of having to ask for confirmations that the auditor may believe are going to be unreliable at the outset. In addition, requiring that auditors use confirmations as an audit procedure when responses may be unreliable may result in auditors using procedures that are not the most effective in the circumstances.
- Making confirmation requests mandatory will likely make the process of obtaining confirmations a perfunctory/compliance-focused process; auditors may focus more on complying with the requirement to request confirmations than on using confirmations as a meaningful response to assessed risks.
- Making confirmation requests mandatory does not reflect environmental issues, such as the culture in some jurisdictions, that prevent auditors from requesting confirmations, or legal issues, such as privacy or confidentiality impediments.
- While confirmations are mandatory in some jurisdictions, the requirements are either non-specific in terms of what has to be confirmed or are supported by protocols between the

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accounting profession and other professions/associations. To incorporate requirements in an international standard would therefore require that the requirement be general to allow for individual jurisdictional differences, or international protocols that will be difficult to achieve. The Task Force understands, for example, that the legal profession does not operate on a consistent basis internationally.

- If confirmation requests were made mandatory, there likely would need to be exceptions to provide for different jurisdictional and other practical considerations.

Task Force Preliminary Conclusions and Proposals

The Task Force has concluded that making confirmation requests mandatory conflicts with the audit risk model, may not improve the quality of audits, and suffers from significant operational disadvantages. The main disadvantage of mandating confirmation requests is that it presumes that confirmations provide relevant and reliable audit evidence. Research and experience have proven that this is a flawed presumption. Accordingly, the Task Force believes that the ISAs should not be amended to require that confirmations be requested to address pre-defined financial statement risks.

The Task Force believes that the decision to use confirmations as audit evidence should reflect a consideration of factors that affect whether confirmations will be a relevant and reliable source of audit evidence. Accordingly, as outlined in Issue 2, the Task Force proposes to make improvements to ISA 505 to assist auditors as they consider these factors and determine whether confirmations are necessary to address assessed risks for specific assertions and, if considered necessary, that the confirmation process is designed and executed in an effective manner.

Matter for IAASB Consideration

6. Does the IAASB agree with the preliminary conclusions and proposals of the Task Force with respect to mandatory confirmations?

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APPENDIX

Results of Task Force Research

A. Results of Survey of National Standard Setters

The purpose of this survey was to obtain information about the use of bank and legal confirmations, the type of information requested for confirmation and the quality of responses. The following summarizes the results.

Bank Confirmations

- Nine countries have an agreement in place with the national bankers association relating to bank confirmations.
- Those countries that do have an agreement with the national bankers association collect virtually the same information on the bank confirmations, although in one case (Germany), the agreement does not specify details.
- Most countries (20) permit auditors to ask open questions to the bank.
- In countries that do not have an agreement with the national bankers association, banks will normally respond to requests for confirmation.
- The quality of responses was considered high in 15 out of 24 countries (though only 3 of the 9 countries with agreements in place with the national bankers association indicated that quality of responses is high). Poor quality confirmations were those not returned accurately, completely or on a timely basis.
- In the few cases where banks do not respond to confirmations, it is because the client has not granted the bank authority to respond, on the basis of cost or for confidentiality reasons.

Communications with Law Firms

- Very few countries (4) have an agreement with the national Law Society or equivalent that specifies the type of information that lawyers respond to.
- In most countries (18) auditors are permitted to ask open questions.
- Not having an agreement with the national Law Society does not seem to prevent lawyers in most countries (19) responding to requests for confirmation. Only in Belgium do lawyers not respond.
- The quality of responses from lawyers was considered to be high by only 50% of respondents. The poor quality of responses was attributed to incomplete and/or inaccurate responses.
- The reasons given for lawyers refusing to respond included: (i) confidentiality; (ii) lawyers are not required to respond; (iii) will not address completeness; and (iv) they do not have sufficient information to make an informed decision.

General Observations and Preliminary Conclusions

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Based on the survey results, the following general observations and preliminary conclusions could be made:

- Because all respondents indicated that auditors are requesting confirmations from law firms and banks, making confirmation requests mandatory may not result in a significant change in practice. On the other hand, it may be desirable to require what seems to be general practice, in order to bring all auditors up to this standard.
- The lack of protocols with legal and banking associations does not generally appear to prevent auditors from requesting confirmations of law firms and banks and receiving responses. In fact, the effect of a protocol may appear to be to restrict the questions that may be asked.
- The quality of responses to confirmation requests is considered high in only 50-60% of the cases. Those jurisdictions with protocols in place do not seem to be obtaining higher quality responses than other jurisdictions.
- As a result of the previous 2 points, it would seem that protocols, by themselves, may not be a factor in improving the quality or rate of responses.
- Quality of responses seems to be a significant issue. However, the survey is inconclusive in identifying the reasons for this. One reason may be that confirmation requests are not well designed. Another may relate to the nature of the information requested.

B. Results of Survey of SMP Committee

The purpose of this survey was to obtain information relating to concerns about the adequacy of confirmations as a reliable source of audit evidence, with particular emphasis on issues that may be specific to audits of smaller entities. The following summarizes the results.

- Failure to identify applicable assertions related to the audit process results principally as a result of the confirmation process being performed as a matter of audit process, or by rote, without an appropriate risk assessment of the applicable audit area being completed. This often results in improperly designed confirmations which often do not include the required information to respond to the assertions being tested.
- Improper design of confirmations is principally because of a lack of consideration of risk assessment and identified audit assertions.
- There is a lack of appropriate professional skepticism in the completion of appropriate alternative procedures; because non-responses are not considered to be an error, may be resulting in inefficient and/or ineffective alternative procedures.

C. Results of Survey of Forum of Firms

The purpose of this survey was to obtain information relating to concerns about the adequacy of confirmations as a reliable source of audit evidence, with particular emphasis on issues that may be specific to audits of larger entities. The following excerpts from the responses summarize the results.

Eight responses were received.

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Question A: which steps in the audit confirmation process do auditors find to be problematic? Why?

- Describing clearly the information about which the auditor is seeking confirmation
- Understanding how the third party is organized in order to design the request appropriately and direct it to the appropriate individual
- International confirmations – dealing with different legal environments, attitudes and modes of confirmation
- Generally, poor response rates, resistance to respond, inaccurate responses
- Performing alternative procedures is often inefficient and done at a late stage in the audit

Question B: Are there any factors specific to different sizes/types of client that affect, either positively or negatively, on auditors' ability to perform the audit confirmation process?

Factors are mostly related to the third party –

- Automation and sophistication of accounting systems at third party
- Whether the client's and the third party's accounting systems "talk" to each other
- Willingness of third party to respond
- Type of entity and industry in which it operates; some industries operate in an environment where confirmations is a well-established practice (e.g. investment advisors)
- Cost of confirming
- Size of client – bigger accounts have more leverage with third parties
- Dealing with overseas parties
- Larger entities generally more complex than smaller ones

Question C: Are there any changes to ISA 505 that could improve auditor performance of the audit confirmation process?

- Requiring confirmation where response rates are poor or where information requires disproportionate time to reconcile would add cost without any quality benefit.
- Illustrative examples of most common confirmation letters
- More on understanding the client's arrangements and transactions with third parties as being key to designing confirmations
- Guidance on professional judgment in determining how to obtain effective audit evidence by all reasonable means; what to do when confirmations will not be effective
- Guidance re obtaining confirmation evidence re side letters and other arrangements
- Authenticating electronic confirmations
- Dealing with causes and frequency of exceptions and their implications on other transactions

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- Expand the scope of ISA 505 to include legal confirmations, internal bank confirmations and inter-company confirmations

Question D: What are the key factors affecting whether confirmations provide greater assurance than other types of substantive procedure?

- Proper identification of related parties; objectivity of respondent
- Response rates
- Proper identification of party to whom to send confirmation
- Appropriately articulating the request
- Diligence of the third party
- The assertion being audited
- Whether the information being confirmed is objective or subjective
- Quality of the client's/third party's accounting records

Question E: Are any of these factors particularly prevalent with respect to the audit of larger clients?

- Larger clients more likely to have complex automated accounting systems
- Difficult to establish independence of third party with larger clients
- Greater leverage with third parties to getting a response
- Two respondents did not think that size of client affected factors

Question F: What types of errors are found in confirmation responses and what do you determine to be the root causes of these errors?

- Respondents identified the usual cut-off errors, systems mismatches etc
- If the request is not in sufficient detail (for example because the auditor is not aware of how the third party deals with confirmation requests)
- Respondent does not have competence to respond
- Respondents not using diligence in responding
- Respondents only willing to confirm specific information requested and not open questions

Question G: Under what circumstances do you consider that other substantive procedures provide as much, if not more, assurance than confirmations?

- When confirmations provide higher quality evidence but response rates are poorer, the sufficiency of evidence may be less than that obtained by other procedures
- Related party transactions
- When evidence can be obtained directly by the auditor by other means
- Alternative procedures are a supplement to and not a substitute for confirmations

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Question H: What issues do you envisage, if any, were confirmations to be made mandatory?

- Mandating will hold up audit completion and at worst impact opinion
- Confidentiality and privilege issues
- Contentious issues may not be identified in the confirmation response
- In US, no particular issues
- Increased volume of confirmations may cause quality to drop
- Low response rates makes confirmations a waste of resources
- Need to be more specific re expectations re identification of previously undisclosed bank accounts and lawyers
- Some countries do not use confirmations
- Non-responses from some third parties means that will be a waste of time in many instances.

Question I: What would you see as possible exceptions to mandatory confirmation, if any, that the ECTF would need to consider?

- Better to require bank and legal confirmations, unless other sufficient appropriate audit evidence obtained or there is specific reasons as to why the confirmation could not be obtained –
 - Legal or regulatory
 - Poor responses in the past
 - Nature of respondent – some industries do not provide responses
 - Other sufficient appropriate audit evidence
 - Low risk
 - Cultural or international barriers
- Could segregate types of confirmations into two. The first could be where there is a direct and contractual arrangement between the client and the third party. In this situation, there would be a rebuttable presumption of confirmation. The second type would be where the contractual relationship is remote where mandatory confirmation would not be required.